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BEFORE THE

PUBLIC SERVICE COMMISSION OF WISCONSIN

Investigation on the Commission's Own Motion into the Need for Changes in Natural Gas Regulation for City Gas Company; Florence Municipal Gas Utility; Madison Gas and Electric Company; Midwest Natural Gas, Inc.; Natural Gas, Inc,; Northern States Power Company; St. Croix Valley Natural Gas Company; Superior Water, Light and Power Company; Wisconsin Fuel and Light Company; Wisconsin Gas Company; Wisconsin Natural Gas Company; Wisconsin Power and Light Company; and Wisconsin Public Service Corporation

Docket 05-GI-108
(Phase I)

FINDINGS OF FACT, CONCLUSIONS OF LAW AND PHASE I ORDER

Introduction

This proceeding is an outgrowth of the Commission's investigation into possible reforms of its regulation of natural gas public utilities in Wisconsin to make regulation more consistent with emerging competition for retail sales of natural gas. In March, 1992 the Commission formed a utility/staff workgroup to identify and evaluate possible regulatory approaches for the natural gas industry in light of federal changes in pipeline regulation under Order 636 and the Commission's own regulatory goals. The workgroup also examined industry trends and how they might affect state regulatory goals. The culmination of the workgroup was a report entitled, "Work Group Report on Natural Gas Regulation in Wisconsin."

In September, 1993 the Commission addressed the report and directed staff to move forward with regulation assuming utilization of the Strategic Problem Solving Approach identified in the report. The Commission also directed staff to look at various market models so a market approach could be utilized in regulation where appropriate.

Pursuing the Commission directive, staff issued a report entitled, "05-SG-100, Phase II Report, Approaches to Natural Gas Regulation in Wisconsin." This report addressed broad policy concerns within the context of four different market models (Models A through D). On July 28, 1994, the Commission addressed the staff report and determined that staff should pursue Market Model D, which deregulates gas costs by customer class as classes become sufficiently competitive. Among other things, the Commission determined that the distribution function is a monopoly and would remain regulated for all classes. The Commission also gave staff direction to unbundle natural gas retail services and increase customer choices.

In this phase of this proceeding, the Commission will address three related issues. First, the Commission will address the manner in which natural gas public utilities may provide service to customers within deregulated market segments under Market Model D. (Separate/Allocate Issue.) The second issue relates to the unbundling or refunctionalization of costs underlying segmentable natural gas utility service. (Refunctionalization Issue.) Finally, the Commission will address two related issues concerning negotiated contracts between LDCs and their customers: whether the Commission should use long-run incremental cost (LRIC) as the standard against which to determine whether negotiated rates for contract services established under sec. 196.194 (2), Stats., are compensatory; and how LRIC should be determined by the Commission. (Contract Rate Issues.)

A prehearing conference was held on April 5, 1995, to clarify the issues to be considered in Phase I of this proceeding and to establish filing dates.

Technical hearings were held commencing May 30, 1995.

FINDINGS OF FACT

THE COMMISSION FINDS:

SEPARATE/ALLOCATE

This issue involves the manner in which Wisconsin natural gas utilities will be able to serve customers in deregulated markets. Under Market Model D, markets will be deregulated when effective, sustainable competition exists for the market. Marketing activities directed to customers in deregulated or unregulated markets cannot be done on a regulated utility basis. Accordingly, the central issue is the degree of financial or structural separation required to be maintained for gas purchasing activities associated with serving regulated markets from those used to serve unregulated markets. Ultimately, resolution of this issue will determine whether natural gas utilities will be permitted to serve unregulated markets using common gas supplies and capacity, with costs allocated between regulated and unregulated activities, or whether such activities must be conducted by separate nonutility marketing entities with their own gas purchasing functions and related costs.

Principles Underlying Restructuring of Natural Gas Industry in Wisconsin

In addressing this issue and the other issues associated with the restructuring of the gas industry, the Commission intends to be guided by the following principles. These principles represent a synthesis of electric restructuring principles and objectives set forth in the initial notice in docket 05-EI-114, but have been modified to reflect current conditions in the gas industry restructuring process.

- Competitive markets are preferred to regulation. Regulatory actions should not frustrate or impede appropriate movement to the most competitive model.
- On a long-term basis, consumers of all customer classes should benefit or at least be held harmless by any changes.
- Deregulation does not guarantee a competitive market. Deregulation of services should only take place where competitive markets exist, are effective, sustainable and in the public interest.
- Any PSC imposed strictures should protect new and unaffiliated market participants from the unfair exercise of market power.
- One of the benefits of competition should be increased customer choice.
- The marketplace should provide access to the maximum amount of information needed by customers to make informed decisions regarding gas service choices.
- Gas utilities should have an opportunity to recover prudently incurred, verifiable, material stranded costs.

- Safe and reliable service must be maintained.
- Regulatory, social, environmental and financial commitments have been made in the past and should not be ignored or discarded in the transition to a new structure.

Separation of Gas Purchasing Activities

Consistent with these principles, the Commission finds that it is necessary to completely separate gas purchasing activities associated with providing regulated sales services from gas purchasing activities associated with providing unregulated services. In reaching this decision, the Commission relied on the experience it gained from monitoring the various marketing pilots which have been in place commencing in July, 1993. The marketing pilots ranged from joint use of utility capacity and supply by the utility and its affiliate, with ratepayers sharing in the profits, to fully-separated affiliates making open market purchases of capacity and supply from the utility. The experience gained by the Commission through review of the marketing pilots was very useful in determining the appropriate degree of separation. Based on that experience, and on the record in this docket, Wisconsin natural gas utilities will be able to serve customers in deregulated market segments through a separate entity (affiliate or subsidiary). This means that the marketing entity's employees and business operations must be located in a physically separate facility that is not occupied by utility employees or utility business operations. The marketing entity's business operations must be self-supporting, having its own telephone system, support services, office supplies, filing system, furniture, computer system, etc., none of which are owned or operated by the utility. The marketing entity must have separate personnel. The utility may provide payroll, pension and benefit support services as well as some administrative support as long as the provision of those services does not increase the costs to the utility ratepayers or jeopardize market-sensitive information of the utility or the marketing entity. The specifics concerning what sharing is allowed will be addressed in individual affiliated interest agreement orders.

Complete separation of gas purchasing activities directed to deregulated markets will serve several desirable goals. First, it will result in utility personnel being focused on their primary business, which is to serve regulated utility customers. If utility personnel operate in both regulated and unregulated markets, inappropriate incentives might arise to the detriment of the utility's core customers.

Second, complete separation may aid the development of competitive markets. Customers in deregulated markets might have the perception that preferential treatment would be accorded customers of the utility's in-house sales structure as compared to customers purchasing from other market participants. Such a perception, even if unfounded, might be a strong inducement to a customer to do business with the utility's in-house sales structure, especially if all competitors offer similar prices for comparable services.

Third, it will ensure that employees transacting business with customers in deregulated markets will not have access to utility data that is not available to competitors. This will go a long way toward ensuring that the success of utility marketing activities in deregulated markets will be based on superior prices or services and not on superior access to utility information.

Fourth, it will protect unaffiliated market participants from the unfair exercise of market power. This record demonstrates that it would be practically impossible to assign upstream gas and capacity costs between regulated and unregulated markets using a process other than a fully allocated costing methodology. Gas is purchased for regulated and unregulated sales with different combinations of price, firmness and basis. Under such circumstances, after the fact it would be practically impossible to ascertain what gas was purchased for the regulated markets and what was purchased for the unregulated markets even if considerable effort were made. Consequently, the danger that the utilities' unregulated marketing activities would be cross-subsidized by their regulated activities is simply too great. Moreover, given the minimal benefits demonstrated in this record arising from use of common gas capacity and supply, the allocation of common costs between regulated and unregulated markets is simply not reasonable.

In many previous cases, this Commission has permitted allocation of common costs between regulated and unregulated activities based on fully allocated costing methodologies. This allocation methodology would probably result in all appropriate costs being recovered from utility customers in unregulated markets. However, our experience under current regulation has demonstrated that this approach is not feasible for allocating common gas procurement costs since it would result in prices for unregulated services which are not competitive.

Minimal Aggregation Benefits

Several parties to this proceeding claimed that permitting utilities to aggregate customer demand in regulated and unregulated markets and allocate gas capacity and commodity costs between them would preserve important economies of scale for remaining regulated customers. One claimed benefit of permitting LDCs to serve both regulated and deregulated markets with common supply and capacity contracts would be greater efficiency (e.g., economies of scale and greater diversity in gas purchasing, greater volumes over which to spread fixed costs, and increased flexibility in utilizing the common assets) than might be realized from serving each market with separate assets.

The record in this proceeding fails to demonstrate that the utilities' remaining sales customers would be substantially harmed by requiring LDCs to serve deregulated markets through separate subsidiaries with no sharing of capacity or supply contracts. While some parties did testify that purchasing gas for a smaller, less diverse core would increase costs and decrease the utilities' ability to meet remaining core customers needs, these claims were not supported through record evidence. In fact, the record does establish that a utility can provide a competitively priced gas service to a customer base consisting of largely residential and small commercial customers.

This is not to say that current LDC capacity and supply portfolios are optimally configured to serve a pared core if deregulation of some firm markets should occur. LDCs acquired their current pipeline capacity portfolios as part of the restructuring of interstate pipelines under FERC Order 636 in order to serve their current firm core customers. In order to acquire necessary pipeline services, the LDCs were required to enter into long-term contracts with the pipelines. These contracts will need to be restructured if significant firm customer loads are lost to deregulation and may give rise to transition costs.

Based on this record, the Commission finds that once adjustments have been made in the level and types of pipeline services and gas supply contracts which are held for provision of gas sales services to remaining core customers, the financial impact on core customers associated with the deregulation of interruptible and large volume gas sales should be minimal.

Appropriateness of Market Model D

Although it was not an issue in this proceeding, several parties challenged the appropriateness of Market Model D. These parties took the position that the Commission had adopted Market Model D without permitting the natural gas utilities affected by this decision an opportunity to present a case for one of the other market models. In this regard, it must be noted that the Commission does not rely on any particular market model in reaching its decision in this docket. Rather, the Commission finds that separation of gas purchasing activities is appropriate regardless of which market model is ultimately selected by the Commission. The appropriate time to revisit the suitability of Market Model D is before the Commission deregulates gas sales services for a currently regulated market. This will need to be done in abandonment proceedings in which a complete record can be considered concerning the persistence and effectiveness of competition and the costs and benefits of deregulation in that particular market.

Transition Cost Recovery

As discussed above, although the long-term financial impact of market segment deregulation on remaining sales customers will be minimal, transition costs may be experienced by the utilities in the process of market-segment deregulation. These transition costs may arise when a utility has a significant amount of capacity contracted for a market segment which is then deregulated. During the transition to Market Model D, gas utilities should have an opportunity to recover prudently incurred, verifiable, material stranded costs. However, any transition cost recovery mechanism must reasonably protect core customers.

When the Commission considers abandonment of sales service to a particular market, a transition plan should be presented as part of the abandonment proceeding. At that time, specific information will be available concerning the markets proposed to be deregulated which will enable the parties to develop a market-specific transition plan. At a minimum, the transition plan must address several matters: the manner in which transition costs will be minimized by the utility (e.g., by contract reformation, capacity release, or capacity assignment to departing sales customers); proposed transition cost recovery mechanisms (e.g., an exit fee from sales service or a distribution service surcharge for customers in affected markets); and the method by which core customers will be protected in the transition. The abandonment proceeding will be a forum for addressing public interest concerns. The transition plan should also ensure that cross-subsidies are eliminated in the transition to Market Model D, and that any subsidies be explicit in the transition. In this context, subsidy refers to explicitly-approved high cost credits or rate buy-downs to achieve public policy objectives, while cross-subsidy refers to the inappropriate shifting of costs and not covering long run incremental costs.

Exceptions to Separation Requirement

Some LDCs in this proceeding have noted circumstances which they believe may require special policy treatment by this Commission. The Commission finds that all LDCs should be treated consistently concerning deregulation issues, but that exceptional circumstances, such as the size of the utility or the timing of deregulation, can be addressed by the Commission on a case-by-case basis.

The timing of deregulation may vary from utility to utility because effective, sustainable competition must be in place before any services are deregulated. The timing of deregulation may also vary from utility to utility because of the varying levels of transition costs. In general, if an LDC has capacity contracts for a segment that is to be deregulated, and that capacity will be stranded by deregulation, the Commission should permit a reasonable transition period so that transition costs will be minimized.

Opportunity Sales by LDCs May Be Permitted Subject to Adequate Safeguards

The advent of FERC Order 636 required LDCs to acquire new, costly assets and services in order to meet the anticipated peak day needs of their firm gas supply customers. It follows that these assets will not be fully utilized by an LDC every day of the year to meet the daily and seasonal needs of its customers. The sale of unused capacity or supply entitlements necessary to meet peak day needs and an appropriate reserve margin will likely remain a feature of regulated gas sales indefinitely and are appropriately characterized as opportunity sales. It is not only prudent that an LDC sell these assets when they are not needed, but it would be imprudent not to make such sales and minimize costs for the ratepayer.

Some witnesses expressed concern over possible anti-competitive behavior, sweetheart deals, and cross-subsidization associated with opportunity sales. Ideally, opportunity sales should be made at a market price established in arm's-length transactions. However, the current market for released capacity is an imperfect one in which transaction transparency is lacking. Such market imperfections only heighten the concerns of unaffiliated market participants who desire to purchase released capacity from the LDCs.

In order to meet these concerns, some parties urged the Commission to prohibit LDCs from making any opportunity sales directly to end-users in unregulated markets. The Commission does recognize that, without transaction transparency, it may be difficult to discern any market manipulation by LDCs. If an LDC has an unregulated marketing affiliate, or is engaged in a strategic business alliance with an unaffiliated marketer, the threat of market manipulation is increased. However, as noted above, opportunity sales are sales of unused contract entitlements necessarily held by an LDC to meet the daily and seasonal swings of its firm customers and are intended to maximize utilization of assets that remain under regulation. The Commission finds it is not in the public interest to unnecessarily restrict the ability of LDCs to make opportunity sales in unregulated markets if such sales will achieve the goal of maximization of asset utilization.

In an imperfect market, how LDCs make these opportunity sales (to whom, at what price, and under what conditions) is very important and the Commission will require that LDCs follow appropriate standards in making such sales. These standards are intended to ensure that all interested market participants have an opportunity to purchase released capacity and supply, and that the releasing utility receives the highest price for the sale. In situations in which an LDC has a marketing affiliate, additional restrictions on transactions between the LDC and its affiliate are necessary in order to ensure fair treatment of all market participants. Several witnesses assumed opportunity sales included sales of excess levels of capacity or commodity resulting from losing customers to deregulation. However, the cost of excess capacity and commodity are to be treated as transition costs, not as opportunity sales, although the ultimate disposition may be very similar.

Commission review of LDCs' capacity and supply portfolios, to ensure that the portfolios are appropriately sized to meet only the needs of the regulated customers, is a necessary step and will diminish concerns of market manipulation. Consistent with this end, it is appropriate for the Commission to develop guidelines or standards for reserve margins for LDC capacity and supply portfolios. Commission staff should address how reserve margin standards or guidelines should be developed and make a recommendation to the Commission as to how this may be accomplished.

Standards of Conduct for LDC Opportunity Sales

As discussed above, the Commission will permit LDCs to make opportunity sales of unneeded capacity and supply subject to appropriate utility standards of conduct. Some parties have suggested that the Commission pattern utility standards of conduct after those required by FERC Order 497. Although some aspects of Order 497 might not be completely appropriate for Wisconsin LDCs, it provides a useful starting point for such rules. Standards should also incorporate the requirements in s. 196.795(5), Stats., which applies to energy holding companies, and which sets standards for, among other things, transfer price, customer information, and cross-subsidies.

Standards of conduct should ensure that LDCs operate in a nondiscriminatory fashion when dealing with market participants. Nondiscrimination means that the LDC will provide access to utility information, services, and unused capacity and/or supply on the same terms for all market participants. Standards of conduct should also establish reporting and recordkeeping requirements adequate to permit the Commission and competitors to monitor the transactions between an LDC and its gas marketing affiliate. In addition, the standards of conduct should require utilities to establish a formal complaint process for the investigation and resolution of disputes between a utility and market participants. Finally, the standards of conduct must be enforceable by injunctive remedies and monetary penalties to ensure that the utilities adhere to the standards.

Some parties suggested that public reporting or disclosure of transactions with affiliates was not necessary to prevent abuses and that reporting to the Commission was sufficient. The Commission finds that public disclosure is necessary to give market participants the opportunity to review what assets were offered and who acquired those assets. Market participants need to be able to review the transactions, not just the Commission. Market participants are often in a better position to identify abusive transactions than is the Commission.

Some parties have urged the Commission to utilize workgroups to address specific issues associated with the Commission's deregulation efforts. This is an area where the involvement of market participants could improve the regulatory process. Accordingly, the Commission has directed staff to establish a workgroup consisting of utility representatives and market participants to prepare detailed recommendations to the Commission for standards of conduct. Until this work can be done, the Commission finds that it is necessary to impose and enforce interim standards of conduct on utilities, as part of its review of the market pilots and when reviewing affiliated interest agreements.

Additional Restrictions on Transactions Between LDCs and Their Respective Marketing Affiliates

Some parties felt that other restrictions or conditions on the transactions between an LDC and its marketing affiliate, in addition to standards of conduct, were necessary to protect market participants from the utilities' exercise of market power. These proposed additional restrictions ranged from divestiture to transfer price restrictions. Most parties, however, believed that a separate affiliate with no shared operating employees, pipeline capacity and/or supply contracts was sufficient when coupled with appropriate standards of conduct.

Based on this record, the Commission finds that it is not in the public interest to forbid capacity and supply transactions between an LDC and its marketing affiliate. However, discounted capacity and supply transactions between a utility and its marketing affiliate - both of whom belong to the same corporate family, share the same corporate goals and financial incentives - cannot be termed truly arm's-length transactions. This means that the transaction price cannot be assumed to be a reasonable proxy for the market price. Consequently, even if such transactions must be made at a market price, the absence of price transparency, coupled with seasonal and geographic price variability, make determination of market price for a specific transaction extremely difficult. At best these transactions would be a proxy for a true market transaction between two unrelated entities with competing goals. At worst they could be collusive with a common goal of advancing their mutual corporate interests.

For these reasons, the Commission specifically directs the standards of conduct workgroup to explore the implementation of a posting or bidding process as a condition precedent for any capacity and supply transactions between utilities and their marketing affiliates. Such a process, if implemented, would open utility capacity and supply transactions to all market participants without discrimination and would provide reasonable assurance that such transactions take place at a market price.

The standards of conduct should also address ways to limit the level of opportunity sales that go to marketing affiliates. The workgroup should consider a percent limitation as well as other limiters. Limits, however, must be balanced, and must result in a level playing field. Once the workgroup has developed recommendations on standards of conduct, the Commission will determine what limits need to be imposed on LDC capacity and supply transactions with its marketing affiliate, and how such limits might be enforced.

Balancing Service

An issue in this proceeding is whether LDCs would be able to provide balancing service to customers within deregulated markets. The Commission finds that, to the extent balancing is offered by an LDC for customers behind its city gates, balancing service should continue to be offered to transportation customers as a best-efforts above-the-line utility service. However, this service may only be offered by a utility to its distribution customers for balancing usage behind the utility's city gates, and may not be used to balance customer usage behind another utility's city gates.

Balancing service was extensively dealt with in docket 05-GI-105, "Investigation on the Commission's Own Motion into the Need for Changes in Tariff Terms and Conditions Necessitated by Recent Changes in the Structure of Pipeline Services Provided to All Gas Utilities." Nothing in this order is intended to supersede or modify the Commission's orders in docket 05-GI-105.

In the Second Interim Order in that docket, the Commission only required that balancing service be provided by those LDCs which are customers of pipelines, like ANR, whose balancing provisions have penalties which default to LDCs and their system sales service. Utilities providing balancing service have purchased pipeline services necessary to meet the anticipated balancing needs of the utilities' system sales customers. For this reason, it is appropriate that the utilities make what are, in essence, opportunity sales of balancing services to transportation customers behind their respective city gates to minimize the cost to system sales customers.

For the same reason, it is not appropriate for LDCs to provide balancing services to customers behind other utilities' city gates. In the Second Interim Order in docket 05-GI-105, the Commission also found that "while there is existing competition to LDC balancing service, it is not robust enough to ameliorate the Commission's concerns about the exercise of LDC market power in balancing for transportation customers." If LDCs were permitted to provide balancing services behind other utilities' city gates, an allocation of costs between regulated and unregulated activities would be required. As discussed earlier in this order, such an allocation of costs would be difficult to make, might give rise to a cross-subsidy between regulated and unregulated activities, and might thwart the development of competitive balancing services. In the future, when the balancing rules are reevaluated, as required by docket 05-GI-105, the Commission may address the provision of balancing services outside of an LDC's city gates.

Obligation to Serve Deregulated Markets

In this proceeding, some parties questioned whether LDCs would continue to have an obligation to serve customers in deregulated markets. Under Market Model D, it is not anticipated that an obligation to serve will exist for any services that have been deregulated. However, this issue will be more fully addressed in abandonment proceedings that must occur prior to any deregulation.

REFUNCTIONALIZATION OF COSTS UNDERLYING UTILITY BASIC SERVICE CATEGORIES (REFUNCTIONALIZATION ISSUE)

LDC Basic Service Categories

In order to unbundle current utility services in the future, and to correctly price such services, it is necessary to be able to identify the LDC basic service categories underlying such services and the costs associated with such categories. The current categorization of natural gas utility costs was developed prior to the restructuring of natural gas interstate pipeline services under FERC Order 636, and does not reflect the changed role of the LDCs in purchasing, transporting, storing and distributing gas to their customers. Consequently, the Commission will provide guidance to the LDCs to assist them in the refunctionalization of their costs.

The process of unbundling utility service involves the examination of the cost centers supporting current utility service, and how these cost centers must be refunctionalized to better reflect the actual utility services that customers receive in the competitive market. This process begins with the identification of the segmentable utility basic services that currently underlie utility service.

In this proceeding, staff proposed five basic service categories into which costs would be refunctionalized: Basic Distribution; Competitive/Basic Supply Procurement; Daily Balancing; Peak Day Backup; and Enhanced/Other Services. The Commission finds that staff's five proposed basic service categories provide a reasonable framework for Wisconsin LDCs to use as a first step to unbundling. The Commission also recognizes that initially there may be situations which require the addition to or deletion of basic service categories; however, any deviation from the staff's five categories must be justified in individual rate case proceedings. The Commission also recognizes that over time additional unbundling and refunctionalization of costs may be desirable and necessary as the market develops.

Staff's five segmentable basic services are cost centers for the following categories of costs:

Basic Distribution. This cost center includes the costs incurred to provide the basic distribution service of transporting natural gas from the gate station to the burnertip.

Competitive/Basic Supply Procurement. This cost center includes the costs incurred to have the gas commodity available at the city gate. This category includes all of the costs associated with the procurement of gas supplies from the different supply areas in addition to any labor-related costs resulting from utilization of interstate pipeline transportation services.

Daily Balancing. This cost center includes the costs incurred in the coordination and management of gas flow to deal with daily variances between customer usage and confirmed nominations.

Peak Day Backup. This cost center includes the costs incurred to ensure delivery of the natural gas supply.

Enhanced/Other Services. This cost center includes the costs related to service elements that may be considered enhancements of choices as opposed to basic service. This category should include costs incurred to provide optional services offered by the utility. It may include the costs of public interest programs which may not be options, but yet should be viewed differently than basic service. Some examples of enhanced services may be custom billing, non-conventional metering options, demand side programs, sales promotion, and fixed pricing options.

Association of Plant Accounts and Expenses to Each Cost Center

There was considerable difficulty addressing the issue of association of plant accounts and expenses with each basic service, since not all parties utilize a common set of basic service categories. In reviewing the different proposals, the Commission finds that staff's Exhibit 23, attached as Appendix B, is a reasonable foundation from which LDCs can build future cost allocations. Appendix B contains the five proposed basic service categories and the plant accounts and expenses associated with each category. Any future cost of service analysis should bear a close resemblance to this appendix. As previously mentioned, the Commission recognized that certain circumstances may arise which will require an LDC to add or delete basic service categories to accommodate a specific utility service offering. This should be done in a rate case filing and be justified by the utility proposing to add or delete other service basic categories.

Allocation of General Plant and Indirect Costs to Each Basic Service Function

This issue involves the method for allocating general plant and indirect costs, such as administrative and general, to the various basic service categories. The evolution of the natural gas industry has transferred the burden of procuring gas supplies and meeting daily swings from the pipelines to the LDCs. Since Wisconsin LDCs typically do not own storage or production area facilities, an approach which utilizes the traditional allocation methods may no longer be appropriate. The Commission finds that a more appropriate allocation methodology should be used in future rate cases.

Staff testified that a more appropriate allocation methodology would involve a labor- or plant-based allocator (or both) which spread costs over the categories they support. A majority of the participating parties either did not address this issue specifically, or testified that a labor-based allocator would be appropriate.

The Commission has previously recognized that there will always be some subjective judgements applied to the allocation of shared or indirect costs. However, when common benefits are present, the Commission has a strong preference for use of the allocators shown on Appendix B to allocate indirect costs. The Commission continues to support direct assignment of cost where appropriate.

Cost of Gas Should be Functionalized into Appropriate Basic Service Categories

Staff testified that where various pipeline and other services support different LDC services, they should be assigned to the appropriate basic service categories. Staff proposed that the gas cost components be functionalized based on the definition of each basic service category, the specific characteristics of the LDC, and the nature of the service being functionalized. Most of the intervening parties generally agreed that the cost of gas should be assigned to appropriate basic service categories. Other parties testified in favor of maintaining the current system of gas cost identification with slight modifications.

The Commission finds that all utilities should unbundle the specific gas cost elements, where they can be readily identified, and should assign the costs to the appropriate basic service categories. Staff will review individual proposals for unbundling of gas costs on a case-by-case basis.

Impact of FERC NOPR (RM95-4-000) on the Refunctionalization of LDC Accounts

The FERC NOPR in docket RM95-4-000 seeks to modify a number of the FERC's uniform system of accounts, including Gas Stored Underground (Acct. 117) and Gas Supply Expense (Acct. 806). Upon reviewing the proposed rulemaking docket, the Commission finds that it would be premature to react to the NOPR in this order, since the FERC has yet to take final action.

CONTRACT RATE ISSUES

At issue is whether the Commission should use long-run incremental cost (LRIC) as the standard against which to determine whether negotiated rates for contract services established under sec. 196.194 (2), Stats., are compensatory; and, if so, how LRIC should be determined. These issues are important to the LDCs and their customers. If negotiated contract rates are too low, utility ratepayers (other than customers who have negotiated contract rates with the utility) will be harmed because they will not receive an appropriate level of contribution from contract customers paying too low of a rate. Also, LDC shareholders will be harmed if they enter into long-term contracts at noncompensatory levels, since they would lose the revenues foregone under noncompensatory rates at least until the next rate proceeding is held.

As an initial matter, the Commission finds that contract service rates, pursuant to s. 196.194(2), Stats., apply only to pipeline bypass situations, or to substitute gas services as stated in the statute, and not to alternative fuels. Contract service rates under s. 196.194(2), Stats., are to be used only when customers might bypass utility service under fully allocated rates. This precludes use of contract rates under s. 196.194(2) to retain a natural gas distribution customer who switches to alternate fuels, such as propane or fuel oil.

The Commission finds that the use of LRIC is appropriate as one element of a contract rate which is considered to be compensatory under s. 196.194(2), Stats. LRIC is the preferred method of measuring costs because it considers all relevant costs incurred over time, by measuring the necessary labor and capital costs required to provide service.

Methods such as short-run incremental cost reflect only current conditions and tend to understate the true cost of providing service over time.

The reasons LRIC must be included in a compensatory rate are cost and consistency. The method for calculating LRIC outlined below should capture all incremental costs a customer imposes on a utility's system. For that reason, LRIC establishes a floor that a contract rate cannot go below without underrecovering costs. In addition to cost recovery, the LRIC calculation method assures consistency by requiring consideration of the same categories of cost for every contract rate customer and LDC. Because LRIC is the floor, or minimum amount needed for cost recovery, the Commission finds that a compensatory rate under s. 196.194(2), Stats. should contain elements for a return on capital and, if possible, a contribution towards general overhead costs. Earning a return is necessary for a viable business and failure to do so could adversely affect the financial standing of a utility in capital markets. A contract rate that recovers LRIC, a return component and contributes something to general overhead is obviously desirable from the LDC and non-contract ratepayer point of view.

A fully-allocated rate has three pieces: LRIC, a return on capital, and recovery of overhead costs. A contract rate that recovered the LRIC and a return on capital, equal to that which the customer would pay under an allocated rate, would be deemed compensatory. Likewise, a contract rate which recovered the LRIC, an appropriate return on capital, and a portion of overhead costs would also be deemed compensatory. An LDC proposing a rate less than LRIC plus a return on capital would have to prove that a higher rate would result in bypass. Finally, the Commission finds that any rate below LRIC would fail to recover costs and would not be compensatory. In this situation, the remaining ratepayers would be better off if the potential contract customer bypassed the LDC's distribution system.

In reviewing the different methods for calculating LRIC in this docket, the Commission finds that staff's Exhibit 18, attached as Appendix C, is a reasonable list of capital replacement costs and operating costs that should be used when determining LRIC for a customer. The Commission finds that LRIC should be calculated by identifying all items that could be affected, on a forward-looking basis, by retaining a customer on the system. For each item on the list, an estimate is made of expected actual costs, which include both capital and operating costs. The determination of LRIC is likely to result in a different mix of costs for each contract rate, because incremental costs will differ based on the service territory and the location of the customer within a service territory. For example, a customer located in a part of a distribution system serving a limited and constrained area will experience different incremental costs than a customer located in a part of the system with excess capacity. But the same categories of costs should be considered in each case.

CONCLUSION OF LAW

THE COMMISSION CONCLUDES:

That the Commission has authority under ss. 133.01, 196.03, 196.194(2) 196.20, 196.37, 196.52, and 196.795, Stats., to enter an order establishing terms and conditions for the determination of rates for natural gas utility service in Wisconsin and to prescribe terms and conditions under which Wisconsin natural gas utilities may provide service to unregulated markets; and that the terms and conditions prescribed herein are just, reasonable, and necessary and in the public interest.

ORDER

THE COMMISSION THEREFORE ORDERS:

1. That Wisconsin natural gas utilities must completely separate gas purchasing and marketing activities associated with providing regulated service from gas purchasing and marketing activities associated with providing unregulated services, in a manner and to the extent consistent with the Findings of Fact.

2. That any opportunity sales, as described in the Findings of Fact, made by Wisconsin natural gas utilities shall be made pursuant to standards of conduct approved by the Commission.

3. That Wisconsin natural gas utilities shall utilize the basic service categories and allocators shown on Appendix B to refunctionalize their respective plant and expense accounts when providing cost of service analyses for the purpose of rate design. If additions to, or deletions from, the basic service categories shown on Appendix B are necessary to support specific utility services, such changes should be presented to the Commission for approval in a rate case or other appropriate proceeding.

4. That, to the maximum extent possible, Wisconsin natural gas utilities shall unbundle specific gas cost elements and allocate them to the appropriate basic service

categories when providing cost of service analyses for the purpose of rate design.

5. That Wisconsin natural gas utilities which enter into contracts pursuant to sec. 196.194(2), Stats., shall submit with a copy of the executed contract, an analysis showing how the contract rate was developed. The analysis shall demonstrate how the development of the contract rate is consistent with the method established in the Findings of Fact and in Appendix C.

Dated at Madison, Wisconsin November 30, 1995

By the Commission.

Lynda L. Dorr
Secretary to the Commission

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See attached Notice of Appeal Rights

Notice of Appeal Rights

Notice is hereby given that a person aggrieved by the foregoing decision has the right to file a petition for judicial review as provided in s. 227.53, Stats. The petition must be filed within 30 days after the date of mailing of this decision. That date is shown on the first page. If there is no date on the first page, the date of mailing is shown immediately above the signature line. The Public Service Commission of Wisconsin must be named as respondent in the petition for judicial review.

Notice is further given that, if the foregoing decision is an order following a proceeding which is a contested case as defined in s. 227.01(3), Stats., a person aggrieved by the order has the further right to file one petition for rehearing as provided in s. 227.49, Stats. The petition must be filed within 20 days of the date of mailing of this decision.

If this decision is an order after rehearing, a person aggrieved who wishes to appeal must seek judicial review rather than rehearing. A second petition for rehearing is not an option.

This general notice is for the purpose of ensuring compliance with s. 227.48(2), Stats., and does not constitute a conclusion or admission that any particular party or person is necessarily aggrieved or that any particular decision or order is final or judicially reviewable.

Revised 4/22/91

APPENDIX A
(UNCONTESTED)

This proceeding is not a contested case under Chapter 227, Stats., therefore there are no parties to be listed or certified under sec. 227.47. However, a discretionary hearing was held, and the persons listed below participated as intervenors.

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(Not a party but must be served)
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Unbundling and Refunctionalization

RATE BASE

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Plant	Intangible	Organization, Franchises and Consents, etc.	Split based on all other plant except General (See below)				
	Production	Propane air and LNG plants			✓	✓ (Mostly)	
	Storage				✓	✓	
	Transmission	Discussed separating this functional category from distribution for COSS purposes; however, we are not recommending separation at this time.					
	Distribution		✓				
	General		Split based on all other plant except Intangible (See above)				
	Reserve for Depreciation	Follows Plant Accounts					

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Other Rate Base Items	Gas in Storage	In the field		✓	✓	✓	
	Materials & Supplies		✓				
	Acct. 190-Accumulated Deferred Income Taxes	Tax effect on contributions primarily related to Mains and Services	✓				
	Acct. 282-Accumulated Deferred Income Taxes	Follows Plant Accounts					
	Customer Advances for Construction		✓				
EXPENSES							
Manufactured Gas Production	All Accounts except for Acct. 728				✓	✓ (Mostly)	
	Acct. 728	LPG		✓			

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Purchased Gas	Acct. 807 (Excluding Odorant)	Purchased Gas Expenses		✓			
	Odorant		✓				
	Acct. 812	Gas Used for Other Utility Operations	✓				
	Acct. 813	Other Gas Supply Expenses		✓ (Mostly)	✓	✓	
Storage (LNG)	All Accounts				✓	✓ (Mostly)	
Transmission	Refer to Transmission Plant						
Distribution	All Accounts including Acct. 879, Customer Installations Exp.		✓				
Customer Accounts	Acct. 904, Uncollectible Accounts		✓				
	EIP Costs		✓				
	All Other Expenses		✓				

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Customer Services	Non Conservation Portion of All Accounts Excluding Advertising		✓				
	Advertising		✓				
Sales Promotion	Associated with Service Extensions	For those costs included in rates					✓
	All Other Expenses	For those costs included in rates					✓
Administrative and General	Accts. 920, 921, 922, 923 & 926	Allocated on the basis of labor					
	Accts. 924, 925 & 935	Allocated on the basis of plant					
	Accts. 928, 930.2 & 931	Allocated on the basis of a combination of labor and plant					
	Depreciation Expense	Follows Plant Accounts					
	Taxes Other Than Income Taxes	Plant related Revenue related Remainder assessment					
	Income Taxes	Follows Rate Base					

Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Return	Follows Rate Base					
Billing options						✓
Metering options						✓
Enhanced metering with unbundled transportation option						✓
DSM						✓
Fixed price options						✓

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Unbundling and Refunctionalization

RATE BASE

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Plant	Intangible	Organization, Franchises and Consents, etc.	Split based on all other plant except General (See below)				
	Production	Propane air and LNG plants			✓	✓ (Mostly)	
	Storage				✓	✓	
	Transmission	Discussed separating this functional category from distribution for COSS purposes; however, we are not recommending separation at this time.					
	Distribution		✓				
	General		Split based on all other plant except Intangible (See above)				
	Reserve for Depreciation	Follows Plant Accounts					

Exhibit _____ (TAM-1)

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Other Rate Base Items	Gas in Storage	In the field		✓	✓	✓	
	Materials & Supplies		✓				
	Acct. 190-Accumulated Deferred Income Taxes	Tax effect on contributions primarily related to Mains and Services	✓				
	Acct. 282-Accumulated Deferred Income Taxes	Follows Plant Accounts					
	Customer Advances for Construction						
			✓				
EXPENSES							
Manufactured Gas Production	All Accounts except for Acct. 728				✓	✓ (Mostly)	
	Acct. 728	LPG		✓			

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Purchased Gas	Acct. 807 (Excluding Odorant)	Purchased Gas Expenses		✓			
	Odorant		✓				
	Acct. 812	Gas Used for Other Utility Operations	✓				
	Acct. 813	Other Gas Supply Expenses		✓ (Mostly)	✓	✓	
Storage (LNG)	All Accounts				✓	✓ (Mostly)	
Transmission	Refer to Transmission Plant						
Distribution	All Accounts including Acct. 879, Customer Installations Exp.		✓				
Customer Accounts	Acct. 904, Uncollectible Accounts		✓				
	EIP Costs		✓				
	All Other Expenses		✓				

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
Customer Services	Non Conservation Portion of All Accounts Excluding Advertising		✓				
	Advertising		✓				
Sales Promotion	Associated with Service Extensions	For those costs included in rates					✓
	All Other Expenses	For those costs included in rates					✓
Administrative and General	Accts. 920, 921, 922, 923 & 926	Allocated on the basis of labor					
	Accts. 924, 925 & 935	Allocated on the basis of plant					
	Accts. 928, 930.2 & 931	Allocated on the basis of a combination of labor and plant					
	Depreciation Expense	Follows Plant Accounts					
	Taxes Other Than Income Taxes	Plant related Revenue related Remainder assessment					
	Income Taxes	Follows Rate Base					

	Acct or Functional Category	Description	Basic Distribution	Competitive Supply	Daily Balancing	Peak Day Backup	Enhanced/ Other Services
	Return	Follows Rate Base					
Billing options							✓
Metering options							✓
Enhanced metering with unbundled transportation option							✓
DSM							✓
Fixed price options							✓

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LONG RUN INCREMENTAL COST ITEMS

Capital Replacement Costs

Plant Items	Assumptions
Local Area Mains	Present Value of Replacement Cost, using Book Life of each section of main necessary to serve customer to estimate when replacements are needed. Local area mains are allocated by percent of throughput to arrive at customer share. Since mains are sized for maximum throughput regardless of interruption for construction projects, allocation could be done on a non-coincident peak (NCP) basis also.
Measuring and Regulating Station Equipment - Gate Station	If Customer's usage is 20% of an area city gate's throughput, a share of the expected replacement of this plant should be included also.
Service Lateral	A convention of Book Life divided by 2 was used to calculate when this would require replacement. Anticipated customer growth may require addition and/or replacement of service laterals also.
SCADA System	If customer's usage is 20% of an area city gate's throughput, a share of the expected replacement of this plant should be included. A seven year technological life is assumed for replacement purposes.
Industrial Measuring and Regulating Station Equipment: Includes Regulators, Relief Valves and Meter Manifolds	A convention of Book Life divided by 2 was used to calculate when this would require replacement. Anticipated customer growth may require addition and/or replacement of these facilities also.
Meter Set	
Miscellaneous	Any capital replacement items not included above that apply to the specific situation.

Operating Costs

Expense Items	Assumptions - Explanations
Odorant	Cost of the odorant chemical plus a portion of the transportation and fill-up if customer's usage is significant in fill area.
Preheater Gas	Estimate in per therm cost
Area Mains O&M Expense	Anticipated O&M allocated using Plant allocation of area mains
Customer Service Lateral O&M Expense	Includes Leak Detection every 5 years
Meter Testing for Industrial Meter - Regulator	Meter and Regulator Inspection Expense (with Labor loadings)
Industrial Rep Contact Expense	Percent of salary with loading
Administrative Costs	Costs included in Administration Charges, e.g. incremental monitoring expenses, incremental billing expenses, etc.
Miscellaneous	e.g. Cost of Daily Balancing Software, Gross Receipts Taxes, combustion inspections on boilers, cost of line location for customer construction, including Diggers Hotline expenses.

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